The Modeling of Financial Instability

'Financial instability' is defined as the ~~development of~~ a financial and economic environment in which small disturbances or shocks can cause large changes over a short period of time in financial relations amongst economic sectors. The repercussions of these large changes permeate through the entire economy. Historically financial instability has been associated with the major booms and the great depressions of experience. A model of financial instability has two facets

Inasmuch as the financial system is not always unstable one aspect of any theory of financial instability is the ~~der~~ specification of processes by which a stable - or robust - financial environment is transformed into an unstable - or fragile - financial environment. With the development and maturation of the Flow of Funds data it is now possible to trace the evolution of financial interrelations amongst and within sectors in considerable detail. Given a theory of how cash flows are related to economic system performance and an interpretation of how balance sheet relations

imply cash flow commitments, it is now possible to develop measures of how accumulated financial relations affect the susceptibility of the economy to financial disturbances.

By integrating the theory and the measures of financial instability with a ceiling and floors view of the endogenous determination of business cycles, a model is derived in which the severity and duration of various cyclical stages of the economy is explained ~~deter. derived~~. This model draws our attention to variables which at present are not well integrated into theories of the cyclical process and it holds out promise of enabling us to both better understand and better predict the performance of the economy.